LATIN AMERICA ECONOMICS UPDATE

Ecuador: political turmoil brings default risks back

- **The looming impeachment trial of Ecuador's president Guillermo Lasso marks a further intensification of the country's political crisis and suggests that the recent experiment with market-friendly governments is on borrowed time. There are lots of ways in which things could play out, but one likely consequence is a shift away from the fiscal austerity of recent years, which could quickly put the public debt trajectory back onto an upwards path. While the sovereign's external debt repayments look manageable for the next few years, it looks increasingly likely that the government won't be able to honour its obligations once debt repayments ramp up from 2026.**

- **What's the latest on the political crisis?** The election of market-friendly Guillermo Lasso as president in early 2021 brought relief for investors. But the past 18 months have been marked by turmoil. Protests flared up in June last year, forcing Lasso to backtrack on some reforms that had been demanded by the IMF. And investors took fright at political developments in February after Lasso's planned constitutional changes were voted down in a referendum and the opposition won major races in local elections.

- The political crisis has ratcheted up further after the opposition sought to impeach President Lasso for alleged embezzlement. The National Assembly has now voted to start an impeachment trial. Lasso survived an impeachment vote last year, but the opposition claims to have enough votes now to remove the president.

- **What happens next?** There are several ways in which things could play out from here. One is that President Lasso survives an impeachment vote and completes the rest of his term (which ends in 2025). Another is that he's impeached and his vice-president Alfredo Borrero (who is from the same party) serves out the remainder of the term. In both cases, it seems like the administration would be bereft of political capital, particularly given the unpopularity of Lasso's reforms and his low approval rating.

- The final option is for Lasso to dissolve congress (the so-called *muerte cruzada*). That would trigger fresh presidential and legislative elections, but in the interim period (which, it's suggested, could last six to eight months), Lasso would be able to rule by decree on urgent economic matters. This is the path that Lasso has suggested he would take (and also that he would run in the subsequent elections).

- While there might be some hope that Lasso would, if able to rule by decree, attempt to pass investor-friendly reforms, we don't buy this argument. These would further reduce his popularity ahead of the following election and could spark protests.

- Whichever way you cut it, it looks like Ecuador's recent experiment with market-friendly governments is on borrowed time and the opposition is in the ascendency. We're likely to see either the current administration carry on for a couple more years in weakened form, or fresh elections in the near term – and most likely a shift in power to the opposition.

- **Why is default risk so high?** The political turmoil has caused spreads on sovereign dollar bonds to surge, with spreads now far above the 1,000bp threshold which is often seen as a marker of debt distress.

- At face value, this seems hard to square with the recent improvement in Ecuador's balance sheet. The government implemented reforms and undertook significant fiscal tightening under an IMF deal (that finished at the end of last year), which helped to flip the current account balance back into surplus while the non-financial public sector (NFPS) budget deficit has narrowed significantly since 2021. (See Chart 1.)

- One commonly-cited explanation for default fears is a concern that an opposition government might trigger a re-run of the 2008 default, when then-president Rafael Correa (who the current opposition are loyal to) chose to stop making payments on two sovereign bonds, saying that they were 'illegitimate'. We doubt that this is likely though. After all, Correa's government became a more reliable debtor over the rest of his time in office (which lasted till 2017). And his chosen candidate for the 2021 election (who lost to Lasso), Andrés Arauz, pledged to honour debts.

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- Instead, we think that there's a more prosaic explanation for default concerns: despite the austerity of recent years, the public debt position remains fragile and could quickly return to an upwards path if fiscal policy isn't kept tight (which is looking increasingly unlikely).
- **How sensitive is the debt trajectory?** The IMF's projections envisage further fiscal austerity and larger primary budget surpluses, peaking at 3% of GDP by 2026, compared with around 2% at the end of last year. If that's achieved, the public debt-to-GDP ratio should fall steadily to 42% of GDP by 2027, from 57% at the end of last year 2022. (See Chart 2.) Were that to happen, it seems plausible that the government would win investors' confidence back.
- But even if Ecuador weren't in the midst of a political crisis, that seems like an optimistic scenario. The Fund's projections envisage a much stronger primary budget balance than our oil price forecast would suggest. (See Chart 3.) Indeed, there are already signs in the monthly fiscal data that the budget deficit is worsening, which is mainly a result of lower oil prices (at least compared with a year ago).
- Our own central forecast, which is based on small primary surpluses, sees Ecuador's debt ratio stabilising at just under 60% of GDP. This scenario is probably on the optimistic side. Given the political backdrop, some form of fiscal slippage is plausible – either if the opposition take power or the current administration tries to bolster its support ahead of the next election. If the government were to run small primary deficits, the debt ratio would rise quickly. (See Chart 2 again.)
- In short, then, the odds seem very much skewed towards the public debt-to-GDP ratio holding steady or rising further. This is unlikely to provide much reassurance to investors and Ecuador seems likely to remain locked out of global capital markets.
- **When does Ecuador face a crunch point?** The good news is that the sovereign has some breathing space. The central bank has accumulated international reserves in the last few years (although we would note that reserve adequacy is still low by international standards). (See Charts 4 & 5.) And external debt repayments are relatively low over the period to 2025/26 – at c.$2bn per year – thanks to the restructuring of sovereign bonds in 2020 and some Chinese loans in 2021.
- FX reserves would probably be able to cover the external debt repayments over the next few years. **But, absent support from other creditors, it seems unlikely that these would be able to cover obligations from 2026 as repayments on restructured debt ramp up**. (See Chart 6. Note that this doesn't take account of the recent blue-bond swap, although our calculations suggest that the effects of this swap are unlikely to be large, particularly up to 2030.) In short, a(nother) sovereign default appears to be on the cards in the second half of this decade.

Chart 1: NFPS Budget Balance & Current Account Balance (4Q Sum, % of GDP)

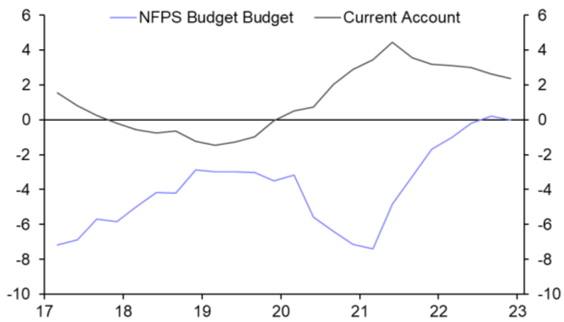


Chart 2: Gross General Government Debt (% of GDP)

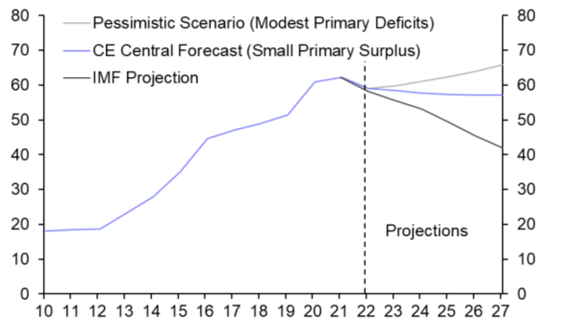


Chart 3: NFPS Primary Budget Balance (4Q Sum)

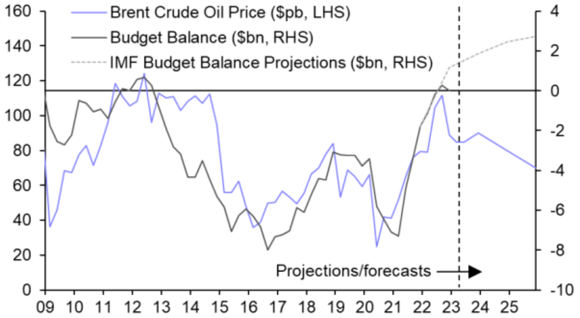


Chart 4: International Reserves ($bn)

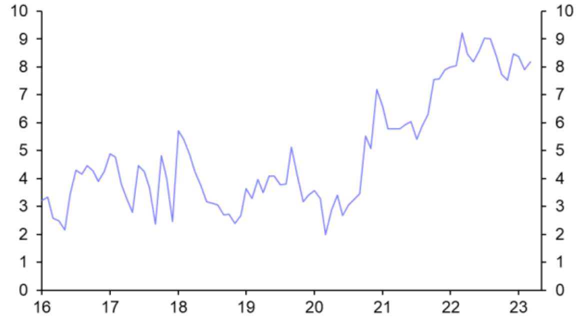


Chart 5: International Reserves (% of IMF ARA Measure, Latest)

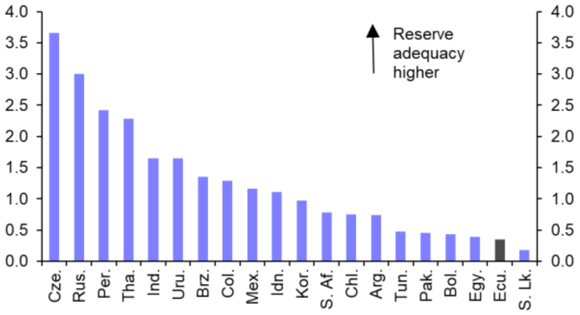
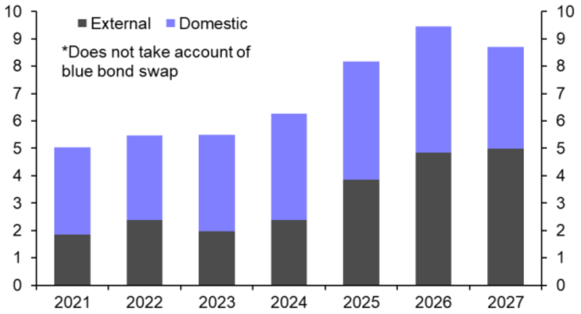


Chart 6: Government Debt Repayments ($bn)



Sources: Refinitv, IMF, Capital Economics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